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Our fiscal policy

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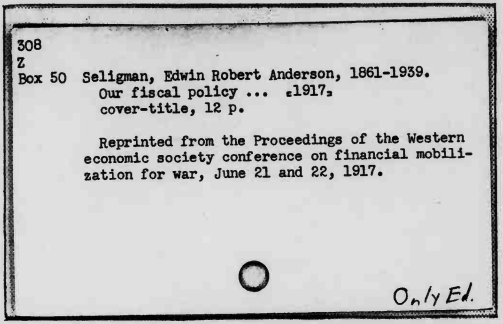
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OUR FISCAL POLICY

EDWIN R. A. SELIGMAN

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OUR FISCAL POLICY

I

The fiscal management of a gigantic war like the present calls for the highest skill. In order to achieve success it must not alone be based on fundamental principles of economics and finance, but must be sedulously adjusted to the mutations of the business world and to the fortunes of the military situation. Important as are the responsibilities of fiscal leadership in times of peace, the real test of statesmanship is to be found during the stress of war. This is especially true at present, for two reasons.

In the first place, this war differs from all its predecessors not only absolutely in the prodigious numbers concerned, but also relatively in the percentage of waste and destruction. Just as in times of peace, under the factory system, man power is economized and machinery utilized with a lavishness which multiplies output, so this is the first war in history where, notwithstanding the hand-to-hand combat of trench warfare, the real issue depends upon the prodigality with which the implements and munitions of warfare are furnished. Not only are these munitions infinitely more costly than in former times, but also less durable: the bigger the gun, the shorter its life; the more elaborate the aëroplane, the greater the chance of its destruction; the better the sanitary methods, the more frequent the casting aside of uniforms; the more complete the application of science, the more rapid the ravages of war by both land and sea. Not only are the initial expenses immensely greater, but the sheer waste by destruction grows with every forward step in efficiency. The present war is not only the most expensive of all wars, but also the most wasteful.

In the second place, the burden will fall with especial severity on the United States. Many of the European belligerents are, if not approaching exhaustion, at least perilously near the point where their powers must begin to flag. Now that we have entered the conflict wholeheartedly, we shall have to do on a large scale, if success is to be achieved, what Great Britain did on a small scale. We shall not only have to perform our part as one of the principal

belligerents but, as is now abundantly evident, we shall have to go far toward supplying the deficiencies of all the Allies, great and little. The rôle which England played during the Napoleonic wars is now to be essayed on a far more colossal scale by us.

In the face, then, of such heavy responsibilities the statesman must be on his guard against three widespread fallacies: first, the underrating of our needs; second, the undue reliance on patriotism; and, third, the slogan of "business as usual."

To the inadequate realization of present needs must be ascribed many of the past failures in the history of war finance. It was because Secretary Chase thought that the Civil War would be short-lived that he adopted his utterly inadequate and soon disastrous fiscal policy. The old story of the speedy collapse of the Central Powers, which we have heard almost from the beginning of the present conflict, is responsible for some of the glaring errors that have been committed by the Allies. Even at the time of our entrance into the war the official calculation of some $6,000,000,000 for our first year's expenditure seemed to many exaggerated. I stated at the time that $10,000,000,000 would be far nearer the mark, and I believe that even that sum is a conservative estimate. Let us no longer delude ourselves with the belief in an impending collapse of the Central Powers or with a hope that our burdens will be speedily diminished.

The second mistake is to think that the economic or fiscal problem can be solved by an appeal to patriotism. Patriotism is indeed essential to the prosecution of a war. Without the willingness on the part of the community to make sacrifices which would be unendurable in ordinary times, no war can be fought to a successful finish. But even this gigantic conflict, with all the heroism and self-sacrifice that it has evoked, has afforded abundant confirmation of the fact that on purely economic questions governments can successfully appeal at bottom only to economic motives. Patriotism does not prevent speculation in war materials or other commodities; patriotism of itself does not succeed in bringing about the necessary reduction of consumption; patriotism does not cause the farmers to increase their acreage unless they are assured a certain minimum price. Even to call a loan a "Liberty

Loan" does not help matters much more than in the case of the ill-starred loyalty or patriotic loans of Europe over a century ago. There are in truth only two ways in which a government can successfully carry on its economic and fiscal affairs. One method is compulsion; that is, so to utilize the sovereign powers of the state as to prohibit people from doing things which in an emergency they ought not to do, and to compel them to do things which the community believes they ought to do. Far more efficacious than compulsion, however, is the appeal to ordinary economic motives. It is vastly more conducive to the success of a loan to raise the rate of interest by one-half of 1 per cent than to attempt to force a recalcitrant purchaser. It is far more promising of results, in order to induce an increase of output, to show the producer that he will profit by the operation than to attempt to penalize him for his failure. The government in its economic activities is primarily amenable to economic considerations. To the extent that patriotism modifies the economic motive it cannot, indeed, be ignored; but woe to the statesman who overlooks the essential characteristics of human nature.

The third danger is the slogan of "business as usual." What is needed in a crisis like the present is not "business as usual" but social productivity at its maximum. These are essentially different conceptions. There must be an enormous increase in the production of all those things which are immediately needed for the war and which are of necessity rapidly destroyed. This change in the form of production, coupled with the diminution in the labor force which results from military service, obviously entails a great decrease in the production of commodities not needed directly or indirectly for war purposes. At the same time the inevitable financial burdens of the war call for a national surplus of production over consumption which must, if possible, be larger than before the war, unless the nation is willing to consume its capital and thus imperil its future economic life. Since at best the total national output is bound to be reduced because of the decrease of the labor force, the only way to secure the needed surplus is by diminishing consumption as a whole. But since consumption for war purposes necessarily increases, it follows that there must be a great falling off

in the consumption of everything else. Such a general decrease of consumption, with enforced economy all along the line, can of course not be attained without a formidable dislocation of industry. Far from business going on as usual, the very meaning of the present war is that business must *not* go on as usual. On the contrary, certain new forms of enterprise must be started and many old forms must be completely transformed. While this process of economic transformation and readaptation presents one of the greatest of economic problems, the fiscal implications are no less significant.

If, then, such immense sums have to be provided, if the appeal must be made to ordinary business motives, and if it is essential to keep social productivity at a maximum, what conclusions follow as to the fiscal management of the war? The first problem, obviously, is as to whether the war ought to be financed by loans or by taxes. As I have been informed, however, that this part of the subject is reserved for another speaker, I shall content myself with the mere statement that the attempt to prosecute a war through sole reliance on either loans or taxes is suicidal, and that the only point worth discussing at all is the relative proportion that ought to be observed between loans and taxes. I have elsewhere[1] pointed out that the proportion originally indicated by the government of 50-50 per cent—that is, one-half of the domestic war expenses to be defrayed out of taxation—is grossly exaggerated, and that in the first year of a protracted war far greater reliance must be placed upon loans. For, whatever may be the disadvantages of excessive loans, they are far more than outweighed by the evils of excessive taxes, from the point of view, not alone of the immediate prosecution of the war, but also of the ultimate economic consequences. Refraining, however, from any discussion of this point and reminding you that for this first year of the war the administration is now definitely committed to the plan of raising more than four-fifths of the required sums by loan, let us consider a little more carefully what should be the future policy.

[1] Edwin R. A. Seligman and Robert Murray Haig, *How to Finance the War*. (Columbia War Papers, Series 1, No. 7.) This has been reprinted by the National Bank of Commerce, New York.

II.

To essay the rôle of critic is at best thankless; and if I venture in this place to call attention to some of the errors that have been committed, it is solely with the hope of persuading the government to avoid a repetition of these mistakes in the colossal loans that will still be needed this year and the following years of the war. We have just borrowed two billions out of the more than eight billions that will be needed; that is, we shall have to borrow during the remainder of the year at least six billions more. And although the Liberty Loan has been placed, if we are to be entirely frank with ourselves we must confess that it might have been more of a success. Instead of being oversubscribed several times, there are a few reserve districts where the allotments have not even been reached, and it was only by the most unremitting and assiduous efforts on the part of the great financial interests, and primarily of much-abused Wall Street, that the loan was carried through at the last. Why is this? Why should so much difficulty have been experienced in placing two billions, whereas even Germany, with its vastly inferior resources, has repeatedly subscribed far greater sums? In my opinion four errors have been committed: first, the failure to appeal to business motives; second, the tax-exemption feature; third, the putting of the cart before the horse; and, fourth, the exaggerated tax policy.

The first criticism is to be directed to the rate of interest. To offer a $3\frac{1}{2}\%$ bond at par when other belligerents at the very outset of the war, with a credit quite as good as that of the United States, issued loans running all the way from $3\frac{3}{4}$ to 5%, is to rely upon patriotism rather than upon business motives. One of the cardinal errors committed by Secretary Chase toward the end of his administration was to decide, against the advice of expert financiers, to issue a 5% rather than a 6% loan, in order, as he thought, to save the interest for the government. The subscriptions from the public came to a sudden stop, and it required the sagacity of a Fessenden to restore the confidence of the public in the financial wisdom of the administration by raising the rate again to the proper business level. There is little force in the argument that it is the duty of the financial community to lend money at

low rates to the government. The government, like any other business institution, must pay the market rate. If a sufficient quantity of funds is not forthcoming at a given rate of interest, the obvious conclusion is that the government is not making a sufficiently liberal offer. It would be as bootless for the government to object to the so-called selfishness of the lenders as it would be for an individual to protest against paying the market rate on his loan. The relatively insignificant amount that is saved by the government in issuing a bond bearing less than the market rate of interest will be more than lost by the inevitable weakening of its credit, due either to the dubious success of the loan or to the quasi-compulsory features of the issue. The ostensible economy of a low-rate bond is dearly purchased in these regrettable consequences.

If it was a matter of doubtful policy to issue the first loan at 3½%, it will in all probability be still more questionable to attempt to keep future issues down to the same rate. It is unreasonable to suppose that we shall be able to accomplish what no country in the world has ever been able to do, that is, to compel people to lend money at what is really less than money's worth. Far better would it be to have a higher-rate-interest loan many times oversubscribed than to have a low-rate-interest loan grudgingly, and in the end perhaps even insufficiently, placed.

The second mistake was to make the bonds exempt from taxation, except as to the inheritance tax. It is needless to call attention here to the grave dangers that will ensue when our national debt amounts, as may well be the case in a few years, to twenty or thirty billions and when our tax-exempt state and local securities will amount to several billions more. The division of a democratic community into two classes of property owners, those who pay taxes and those who do not, is more perilous than the present division into two classes of income recipients. But entirely apart from these social hazards, from which it should be the duty of a great statesman to free us, the bond-exemption clause is in part responsible for the early sluggishness of the first loan. Many a wealthy individual who would have invested in the loan was deterred by the consideration that if he purchased largely he would

before long have the finger of scorn pointed to him as one who had attempted to evade his share of taxation. Even now the mutterings have begun.

Moreover, while the community loses through this appearance of inequality, the government does not gain. On the contrary, especially in a contest like the present one, where it is probable that the rates of the income tax will be gradually increased as the pinch becomes more pronounced, what the government saves in the lower rate of interest on a tax-free bond will soon be more than wiped out by what it will lose in the shrinkage of the income-tax receipts. It is earnestly to be hoped that when the next loan is issued the tax-exempt feature will disappear. At all events let us follow the English example of allowing a choice between taxable and tax-free bonds, so arranging matters that the former will be preferred. The adjustment as between the federal and state securities can easily be made.

In the third place, it must be confessed that the administration in some respects put the cart before the horse. It is an admirable policy to publish no announcement until all preparations have been made, so that when the issue is finally arranged advantage can be taken of the incipient enthusiasm to float the loan successfully on the crest of the wave. But what is the history of the two-billion-dollar loan? First, the announcement was made that the money would be borrowed, but without specifying any details or terms; then, when after some delay the terms were announced, the statement went forth that the loan had been oversubscribed; finally, after attention had been called to the fact that according to the provisions of the law we should not depend upon a syndicate of bankers but should rely upon a direct issue by the government, the situation became so ominous that these very bankers had to come to the rescue of the government and place all their facilities at its disposal.

When the next loan is issued, let us hope that the campaign will be mapped out in advance to the smallest detail; that no announcement will be made until all arrangements have been consummated; and that if the government is again compelled to rely upon the banking community it will neither shun close co-operation nor begrudge generous acknowledgment.

The fourth mistake was the exaggerated tax policy. An adequate tax basis for the impending loan was indeed necessary and the Secretary of the Treasury is to be commended for not succumbing to the danger which befell Secretary Chase during the Civil War. But when the House completed its draft of the revenue bill with excessive and ill-advised taxes, with the adoption of the 50-50 per cent theory of the administration, and with the fear on the part of the community that this same ratio would be applied to the sums still to be called for during the remainder of the year, the enthusiasm of the investing public was suddenly chilled. The apprehension that ill-judged taxes on industry and income would tend unduly to curtail the surplus needed for capital investment in new enterprises and would lead to a shrinkage in security values led many a would-be investor to doubt whether he might look forward to a sufficient balance to invest in government bonds or to justify him in extending his liabilities by borrowing from the bank for the purpose. The exaggerated tax policy thus not only endangered the maintenance of stable business conditions, but imperiled the loan policy itself, and the government was in danger of falling between two stools on both its loans and its taxes.

Let us hope that before the next bond issue is announced a moderate, equable and statesmanlike tax policy will have been adopted—a policy which will not only tend to maintain social productivity at its maximum, but will serve as a support rather than a drawback to the new loans.

III

If our loan policy is susceptible of improvement, what is to be said about our tax policy? Such a policy has not yet been adopted. There are at the present time before the country two theories—the House theory and the Senate theory. The fundamental difference between these may be summarized as follows:

1. The House believes in raising by taxation several hundred millions more than the Senate considers wise or necessary.

2. The House imposes upon higher incomes rates which have never before been tried in civilized society, while the Senate follows a policy of far greater moderation.

3. The House selects for its excess-profits tax a base which the Senate considers inequitable and unworkable.

4. The House suggests large gross-receipts taxes on business, while the Senate prefers to derive a similar revenue from selected excises on commodities.

5. The House proposes a ten per cent increase on all imports, which the Senate declares absurd and unjust.

6. The House levies burdensome taxes on communication and transportation which the Senate declares both unnecessary and unscientific.

As between these two theories it is not difficult to decide, for the House policy bears every mark of haste and lack of consideration. As I have in another place criticized it in some detail, I shall content myself here with stating what is believed to be a sound policy, not only for the immediate future, but for the remainder of what may be a protracted war.

1. In the first place, the amount to be raised by taxation should be carefully adjusted to the conditions of social productivity. In the first year of a great war we should attempt to raise by taxation only enough to defray the interest on the new debt, together with a moderate amortization quota; that is, such an amount, over and above interest, as is calculated to sink the debt well within the generation that contracted it. To do more than this would be likely to engender those dangers which I have elsewhere[1] characterized, as follows:

a) Excessive taxes on consumption will cause popular resentment.

b) Excessive taxes on industry will disarrange business, damp enthusiasm, and restrict the spirit of enterprise at the very time when the opposite is needed.

c) Excessive taxes on incomes will deplete the surplus available for investments and interfere with the placing of the enormous loans which will be necessary in any event.

d) Excessive taxes on wealth will cause a serious diminution of the incomes which are at present largely drawn upon for the

[1] *The House Revenue Bill. A Constructive Criticism.* (Columbia War Papers, Series 1, No. 16, p. 8.) This has also been reprinted by the National Bank of Commerce, New York.

support of educational and philanthropic enterprises. Moreover, these sources of support would be dried up precisely at the time when the need would be greatest. A government already strained by the necessity of immediately adopting many new functions for war purposes would be compelled to assume a number of additional functions now performed through private individuals. The difficult and hasty transition from private to public activities would in all probability entail a considerable loss and would seriously cripple the efficiency of our war activities.

e) Excessive taxation at the outset of the war will reduce the elasticity available for the increasing demands that are soon to come.

In the second year of the war it will be not only possible but desirable to increase the proportion of taxes. It will be possible because the expansion created by vast governmental expenditures will cause widespread prosperity; it will be desirable because it is precisely during this period of expanding profits that the burden will be less felt than at the expiration of the war, when the long-deferred reorganization in industry must take place. With every additional year of war a greater proportion can be raised from taxation, so that ultimately, during the period of the war itself, the way may be paved for the disappearance of the debt entailed by the conflict.

2. The chief reliance during the war must be on an excess-profits tax levied according to scientific principles. Since these war profits will cease with the war, it is only proper that they should form the basis of the extraordinary war revenue. Here again, however, due caution must be observed. In the first year of the war the amount of profits taken by the government must not be so high as to endanger the inducement to the sorely needed expansion of industry. With every succeeding year a greater percentage of the excess can be assessed, until we reach even the 80 or 90 per cent which is to be applied in the fourth year of the war in some of the belligerent countries. Into the much mooted question of the exact form to be assumed by the war-profits tax I shall not here enter.

3. A smaller, but still important, share of the extraordinary revenue should come from the income tax. As the income tax,

however, must remain our chief reliance after the termination of the war, it is of the utmost importance not to exaggerate the burden during the war and especially during the early years of the war. This caution is re-enforced by the close connection mentioned above between the income tax and a successful loan policy, as well as by the consideration that in a democracy like ours a great share of what in other countries constitutes public expenditure is defrayed out of the surplus income of individuals. An income tax with rates sufficiently high to enforce a diminution in consumption is eminently desirable; an income tax with rates so inordinately high on the larger sums as to lessen the flow of private philanthropy would be deplorable.

4. Since it is unlikely that even with the greatest care a gigantic war can be long conducted without trenching somewhat on the capital of the community, it seems that an obviously suitable source of revenue is the inheritance tax—the only kind of a tax on capital which is feasible in a country like the United States. This is not the place to enter into the grave questions that here arise as to the adjustment between state and federal taxation of inheritances; but if it became necessary to make a choice between excessive income taxes and moderate inheritance taxes, my preference, during the continuance of the war at least, is for the latter.

5. To rely entirely upon direct taxes is as impossible as it is unwise. In the selection of indirect taxes, however, a definite gradation should be observed. At the beginning we should content ourselves with impositions on articles of quasi-luxury, like liquors, tobacco and automobiles. With the next step we approach articles of wider consumption, like tea, coffee and sugar. Still another stage is reached when we seek to secure large receipts from stamp taxes. A fourth series of revenues can be obtained by laying under contribution the processes of transportation and communication. It is only as a last resort that we should utilize the general excises or levies on commodities at large, such as we employed during the Civil War. In this gradation, however, not only should a due balance be observed between direct and indirect taxes, but everywhere and at all times we must keep in mind the essential necessity of maintaining unimpaired the flow of capital to new

enterprises. The fiscal problem in war time is not merely the problem of the relative burdens on the various classes in the community, important though that be; the fundamental problem is to invigorate industry, to maintain social productivity, and to render possible the unimpeded prosecution of the war, which can be accomplished only by a steady and undiminished flow of the social income. I should be the last to deprecate the fiscal aspects of social reform, but a fiscal war policy which is predicated primarily on principles of social reform will be likely to lose the war. No greater mistake could be made than to confuse the policies of war finance with those of peace finance.

During the dark days of the Civil War Mr. David A. Wells contributed largely to restoring the waning confidence in the North by his remarkable pamphlet, *Our Burden and Our Strength.* The situation today is quite different. Our strength is unquestioned and our burden is, thus far at least, relatively light. But the forces against which we are arrayed must not be underestimated, and it is the part of wisdom to make provision for all eventualities. A hand-to-mouth fiscal policy is certainly deplorable; but no less illegitimate would be a policy which fails to note the intimate dependence of future fiscal possibilities upon future economic conditions. We need not only a long look ahead, but a wise look ahead. If, as we confidently believe, the fiscal policy of the government will be characterized by the same foresight and expert cooperation which is gradually manifesting itself in the other phases of administrative activity, we need have little reason to doubt the ultimate issue.

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